consumers, skew returns for cable investors, and send the wrong signals to potential entrants.[36]

The Commission should adopt TOC to avoid these very problems. Coupled with a competitive market value approach to rate base valuation in the initial transition to rate regulation, TOC will allow the Commission's cost-of-service standards to produce rates going forward that truly replicate those of a competitive environment.

IV. THE COMMISSION SHOULD ADOPT STREAMLINED PROCEDURES AND SUBSTANTIVE STANDARDS THAT WILL ALLOW FOR EFFICIENT, EASILY REVIEWABLE COST-OF-SERVICE SHOWINGS

Viacom proposes below additional components of a comprehensive cost-of-service regulatory regime capable of assuring reasonable rates for cable consumers, full cost recovery for operators, and streamlined administration for operators and reviewing authorities. After resolving the fundamental issue of correctly identifying and valuing the rate base, a streamlined process for cost-based rates must address each element of cost-of-service cases in a simple and administrable manner, including:

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[36] This is an especially important concern if the Commission's cost-of-service rules are to serve the congressional intent of spurring competition in cable services. To do so, they must provide for a method of valuing the cable rate base that produces rates that signal to the market a proper value for cable service and, in turn, lead to appropriate levels of investment.

- A reasonable rate of return;
- Proper depreciation schedules; and
- Measurement of appropriate operating expenses.

Viacom outlines its suggestions below as to how the Commission should treat these elements to reduce the collective burden of preparing and reviewing cost-of-service showings,[37] while still ensuring reasonable cable rates.

A. The Commission Should Set A Uniform, Industry-Wide Rate of Return Which Accounts for the Risk Inherent In the Cable Industry

The NPRM poses the basic question of whether an industry-wide rate-of-return should be set and, if so, at what level. Cost-of-Service NPRM at ¶ 46. For the reasons explained below, Viacom supports the analysis of the Kolbe/Borucki Study, attached to the comments of Cablevision Industries Corporation, et al., and accordingly urges the Commission to prescribe an industry-wide rate of return at the upper end of the range of 12-16 percent.

[37] Although Viacom's proposed set of streamlined cost-of-service components should prove sufficient for most cable operators, Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1943), and its progeny make clear that cable operators that would be denied a reasonable return even by this streamlined cost-of-service regime are constitutionally entitled to an opportunity to make a full cost-of-service showing.

As a preliminary matter, there should be little question that the Commission should prescribe a uniform national rate of return for cable systems. It has, in effect, already done so in the context of regulating equipment basket rates by setting a reasonable rate of return on investment in equipment. See Benchmark Order at 811 n.715. No reason has been offered, and indeed no reason appears to exist, for applying a different approach to cable service rates. The market for capital knows no geographic limits, and the Commission should not create a preference for some geographic areas over others.

In setting a rate of return, the Commission must of course carefully balance investor and consumer interests. Hope Natural Gas Co., 320 U.S. at 603; see also Bluefield Waterworks & Improvement Co. v. Public Ser. Comm'n of West Virginia, 262 U.S. 679, 693 (1923) (regulated firm is entitled to a return equal to investments of comparable risks). The NPRM proposes to do so by using a combination of a discounted cash flow (or "DCF") approach and a risk premium analysis,[38] with the Standard & Poors 400 Industrial index

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[38] See Cost-of-Service NPRM at ¶ 51 n.54 (explaining how DCF calculates current dividends, stock prices, and anticipated long term earnings growth to estimate the return on equity demanded by investors) and n. 55 (explaining how "risk premium" analysis estimates the cost of equity by comparing historic data on equity returns and bond yield to establish a premium to be added to current long term bond rates).

("S&P 400") serving as a surrogate for the cable industry in prescribing a rate of return. See Cost-of-Service NPRM at ¶ 50.[39]

Viacom endorses Kolbe and Borucki's reasons for not relying on a DCF model to set a rate of return. Rather, Viacom urges the FCC to adopt a "risk premium" approach. In applying a risk premium analysis, however, the Commission must recognize that cable companies, like most companies in a rapidly growing industry, are typically more risky and thus offer a correspondingly greater expectation of returns than the industries represented in the S&P 400.[40] This is confirmed not only by the fact that many cable companies typically pay little if any dividends, a trait characteristic of high-growth, high-risk companies, but also by the significantly higher "betas" of their stock prices, as shown by the Kolbe/Borucki Study.[41] In particular, the Study's

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[39] The Commission also sought comment on the effect of capital structure on the cost of capital. Viacom directs the Commission's attention to the Kolbe/Borucki Study, which explains that the debt/equity ratio does not materially affect the overall cost of capital, except at high levels of debt. However, the Commission must recognize that the proportion of debt directly affects the cost of equity capital. As the proportion of debt increases, so also does the cost of equity capital.

[40] The Commission has recognized that the cable industry is still a relatively new industry, characterized by growth and reinvestment. Cost-of-Service NPRM at ¶ 49.

[41] "Beta" is a measure of the volatility of the price of a stock compared to that of the market. A beta of more (continued...)

analysis demonstrates that the publicly traded cable companies for which data were reviewed have betas significantly greater than that of the S&P 400, which itself already possesses a beta significantly greater than that of the major local telephone companies. Furthermore, the cable companies' betas have steadily increased over the past six years.

The cable industry's impending transition from unregulated to regulated status, compounded by looming competition from wireless cable, direct broadcast satellite, and telephone companies, only heightens this already significant risk. These reasons counsel for recognizing cable operators' cost of capital to be commensurately higher than that of the companies comprising the S&P 400.

The proper nationwide rate of return therefore should be set at the upper end of the range found by Kolbe and Borucki to be reasonable -- approximately 16 percent -- to allow cable operators to recover the legitimate costs of providing cable service. Used in conjunction with trended original cost, this rate of return will still protect subscribers from unreasonable rates.

As with other industries regulated by this Commission on a cost-of-service basis, the Commission should also allow

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[41](...continued)
than 1.0 indicates a volatile stock; a beta below 1.0 is a more steady stock. The S&P 400 has a beta of about 1.0.

cable operators to earn through efficiencies an additional margin of one percent over the established rate of return.[42] Thus, cable companies should be allowed to target their rates at the established rate of return level, but be able -- without rate increases -- to earn an additional one percent through efficiencies.

B. Cable Assets Should Be Depreciated At The System Level On A Straight-line Basis Over Their Economic Lives

Proper depreciation practices are critical to achieving many of the public interest goals of the Cable Act of 1992. Depreciation schedules that are unrealistically slow will send improper signals to the marketplace by artificially reducing rates. This, in turn, will make entry difficult for new competitors and act as a disincentive to investors, resulting in slower deployment of new technologies and other system improvements. On the other hand, too rapid depreciation schedules will lead to unnecessarily high cable rates and thus inhibit the ability of cable operators to respond to price competition. Viacom suggests that a proper middle ground would be reached by: first, establishing broad

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[42] The Commission has, in the past, established such "efficiency" incentives by permitting companies, without changing their rates, to exceed their rates of return by 0.25 percent for local exchange companies, 0.50 percent for AT&T, and 1.00 percent for Comsat. _See_ 47 C.F.R. §§ 65.700(b) and (c); _Communications Satellite Corp._, 68 F.C.C.2d 941 (1978); _Communications Satellite Corp._, 56 F.C.C.2d 1101 (1975).

categories of assets on a system-wide basis; and, second, permitting operators to depreciate the assets over their economic lives on a straight-line basis.

The Commission should establish categories into which operators would assign their depreciable assets as broad as, for example, plant (both outside and inside), buildings, vehicles and maintenance equipment, and home equipment. Specifying such general categories of assets would be consistent with the approach the Commission has taken to customer equipment charges.

Once categorized, these assets should be depreciated on a system-wide basis.[43] Leaving the choice of depreciation schedules to local franchising authorities would potentially saddle an operator with a different depreciation schedule for every franchise area. For example, Viacom's Puget Sound system serves 71 franchise areas. It would be nonsensical to create a regulatory regime that could potentially subject the Puget Sound assets to 71 different depreciation schedules. Moreover, depreciation subject to the whims of myriad local authorities would send unpredictable and likely incorrect economic signals to cable investors and competitors, thereby impeding infrastructure development. As the Commission has stated, "improper capital recovery could delay or prevent

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[43] Assets recorded on a cable operator's books at a level higher than the system level would need to be allocated to the system level before rates could be developed.

modernization which would add to the costs borne by ratepayers and could, ultimately, threaten carriers' ability to fully recover their invested capital."[44]

These categorized assets should then be depreciated on a straight-line basis over their economic lives. The FCC already has adopted straight-line depreciation for its customer equipment regulation. No reason exists to have different depreciation philosophies for different aspects of rate regulation. Moreover, straight-line depreciation will protect consumers by discouraging operators from replacing plant before it is economically appropriate, yet still permit the installation of newer plant when economically desirable based on the expected useful lives of the assets deployed.

Consistent with its policy regarding equipment charges, the Commission should give cable operators discretion to determine the appropriate economic life for their assets in accordance with Generally Accepted Accounting Principles ("GAAP"), which operators are already under an obligation to follow.[45] Viacom submits that this approach of straight-line depreciation over the economic life of the asset

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[44] Amendment of Part 31 Uniform System of Accounts for Class A and Class B Telephone Companies, 92 F.C.C.2d 864, 877 (1983).

[45] The salvage value of most cable physical assets is insignificant due to the pace of technological change. It would be most practical to allow cable operators to establish their own salvage value if warranted by the conditions then prevailing in their geographic location.

appropriately balances the interests of cable operators and consumers alike.[46]

C. The Commission Should Adopt Simple Cost Allocation And Cost Accounting Rules That Recognize Cable's Digital Future

Allocation rules must be designed not only to properly assign costs, but to do so through a mechanism simply and readily applied by the cable industry and its reviewing authorities. Viacom suggests that the Commission's existing regulations for home cable equipment would also meet this test. Even if the Commission disagrees with Viacom's proposal explained further below, in no event should the Commission use "channels" as an allocator of costs between regulated and non-regulated activities.

1. Cost Allocation And Accounting Rules For The Cable Industry Should Be Easy To Apply

The Commission has already adopted straightforward cost allocation requirements for cable customer equipment charges, along with accounting rules and forms requiring cable

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[46] The Commission has authority under Section 543 of the 1992 Cable Act to establish cost-of-service rules, including rules as to depreciation, that are binding on local franchising authorities. This specific grant of authority distinguishes these cable regulations from the FCC's unsuccessful preemption of state depreciation policies in the telephone industry. See Louisiana Pub. Serv. Comm'n., 476 U.S. 355.

operators to maintain their books in accordance with GAAP.[47] Viacom respectfully submits that few additional requirements are necessary for cost-of-service showings.[48] Requiring any greater detail than that proposed in Appendix A to the Cost-of-Service NPRM would be unnecessary and unduly burdensome.

In particular, requiring cable operators to maintain some counterpart to regulated telephone companies' Uniform System of Accounts ("USOA") would be regulatory overkill. Cost allocation and accounting rules are intended to assure both that customers of regulated services do not pay the costs of nonregulated services and that regulated costs are properly apportioned across different categories of regulated services customers. An accounting system as detailed as the USOA is simply unnecessary to accomplish these objectives in the cable industry.[49] Furthermore, a USOA system would be extremely difficult to establish and administer for the simple reason that cable operators have not had reason to maintain, and thus generally have not maintained, their records in that degree of detail.

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[47] See 47 C.F.R. § 76.924 (a).

[48] See Cost-of-Service NPRM at ¶ 59.

[49] Cable systems' pricing schedules are far simpler than those of telephone companies, which typically maintain separate tariffs for switched and special access services or for different types of transmission facilities (often with usage- and distance-sensitive rates). Moreover, setting cable rates on a tier-neutral basis alleviates concerns over possible cross-subsidization across regulated tiers.

2. The Commission Should Allow Cable Operators To Aggregate Costs, Other Than Franchise-Specific Taxes And Obligations, On A System-Wide Basis

The Commission recognizes that there exists a "continuum between the poles of attempting to uniquely identify all the costs of a franchise, and MSO-wide cost averaging."[50] Viacom recommends that the Commission select a middle point on this continuum, allowing cable operators as a rule to average their costs on a system-wide basis.[51]

The NPRM accurately notes that multiple system operators could face the need for potentially hundreds of cost-of-service proceedings, as any one of their cable systems may serve numerous franchise areas. For example, as noted earlier, Viacom's Puget Sound system alone serves 71 different, but contiguous franchise jurisdictions. If Viacom were required to base its cost-of-service showings on franchise-specific costs, it would need to develop and maintain 71 different complete sets of detailed cost data. Yet, as the Commission's benchmark table recognizes, it is indeed the size of a system, measured by its number of

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[50] Cost-of-Service NPRM at ¶ 60.

[51] Franchise-specific taxes and obligations, however, would be added on a franchise-area basis. Joint and common costs incurred at a company-wide level could be allocated to systems according to the provisions of Section 74.924 of the Commission's Rules.

subscribers, rather than that of a particular franchise or the entire company that affects rates.

Averaging the revenue requirement on a system-wide basis would also, as the NPRM recognizes, simplify cost-of-service proceedings.[52] Use of system-wide rate base and operating expenses, together with a nationally uniform rate of return, would substantially reduce the burdens on cable operators.

3. Any Cost Allocation Method Used For Apportioning Between Regulated And Unregulated Services The Substantial Value Of System Upgrades And Other Joint And Common Costs Must Recognize The Coming Digital Environment

Viacom believes that the Benchmark Order established reasonable principles for allocating costs between regulated and unregulated services that should be applied as well to overall cost-of-service showings.[53] Should the Commission conclude otherwise, however, Viacom strongly urges it in any event to reject any concept of allocating costs on the basis

[52] The NPRM (at ¶ 65) asks in what ways a cost-of-service showing in one franchise area would affect rates based on the benchmarks or cost-of-service showings in other, related franchises. Under Viacom's proposal, of course, the potential for disparate regulation of rates in related franchises -- and the burden of making cost-of-service showings in each of multiple franchise areas served by the same system -- would be eliminated.

[53] 47 C.F.R. § 76.924(e) & (f). These rules require cable operators to allocate costs directly where possible, then to assign costs indirectly on cost-causative principles, and finally to apportion any unallocated costs on the basis of the ratio of distributed costs.

of channels -- other than in the short-run to ensure neutrality between regulated tiers.[54]

The concept of a video "channel" derives from the world of analog transmission and is meaningless in the emerging world of digital communications. Capacity in the digital world is measured in terms of bit rates, not in terms of a six MHz video channel or any other bandwidth. Over time, the use of compression technology will render the concept of a "channel" all the more anachronistic.

This Commission has already recognized, in the context of international telecommunications, that channels are not an appropriate measure in a digital environment. See American Tel. & Tel. Co., 98 F.C.C.2d 440 (1984).[55] In addition, a

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[54] See Cost-of-Service NPRM at ¶ 64. Section 76.924(e)(2) provides that service costs should be allocated to each regulated tier based on the ratio of channels in that tier to the total number of channels offered in the franchise area, including nonregulated and leased commercial access channels. While the use of channels for this limited purpose is not problematic for the moment, this regulation too will need to be revisited as the notion of "channels" is rendered meaningless for any allocation purpose.

By channels, moreover, Viacom refers as well to "virtual channels" or other such channel equivalents that might be created to attempt to address the obsolescence of the concept of channels in a digital environment.

[55] The Commission stated in that case:

> Digital fiber optic technology produces a transmission system which differs significantly from conventional analog cables. In a digital system, communications are converted from a wave function into a series

(continued...)

report prepared by the Commission's Office of Policy and Planning has observed that the already difficult questions of allocating costs and pricing service "will be many more times difficult in an integrated broadband environment when each customer is served by a gigabit or terabit optical pipe the use of which is dynamically reconfigured as the customer uses different services and facilities."[56] The analysis concludes that applying traditional cost allocation and cost-of-service ratemaking principles to digitized video communications could produce highly anomalous results and would raise important issues of pricing policy. Similar concerns apply in the context of the cable industry as well.

Currently, Section 76.924(f) of the Commission's Rules, which requires the exclusion of direct and indirect costs of

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[55](...continued)

> of binary digits or 'bits'. . .. In an analog system, on the other hand, communications are represented in their original wave form. They are transmitted as continuous electrical signals which carry information by means of variations in amplitude or frequency.

98 F.C.C.2d at 444. In that proceeding (the TAT-8 Section 214 authorization), the applicants assigned ownership units on the basis of Minimum Assignable Units of Ownership which were defined as a basic usable bit stream of 64,000 bits per second ("bps") plus an additional 9,684 bps for multiplexing.

[56] Pepper, Through The Looking Glass: Integrated Broadband Networks, Regulatory Policy and Institutional Change, OPP Working Paper 24 (FCC Nov. 1988) ("Pepper Study") at 43. The Pepper Study discussed, in particular, the problems that could arise when traditional voice telephony and video signals are both transmitted over a digital system.

nonregulated services from the cost categories used to develop rates for regulated services, does not use a "channel" allocation factor. This is the correct approach to the allocation of costs between regulated and nonregulated services, and no change is appropriate here.

D. Viacom's Proposal Would Result In Simplified, Effective Cost-of-Service Proceedings

The proposal presented by Viacom in these comments provides for a comprehensive, yet simplified form of cost-of-service rate regulation. By blending uniform cost-of-service standards with an operator's particular costs, it provides for regulation that is both cost-based and company-specific. This approach also offers the virtues of fairness to consumers and operators, as well as ease of administration.

In its overall concept, the Viacom proposal resembles the cost-of-service alternatives described in paragraph 61 of the NPRM. Under this concept, the Commission would prescribe unitary, industry-wide standards for identifying and valuing the rate base, for setting the rate of return, and for governing depreciation. In this way, a system's cost-of-service showing would be quite simple.

Each operator would develop its rate base and operating expenses showing directly from its books, which would be maintained according to the Commission's requirements. The Commission could require all operators annually to submit an auditor's statement that their books are being kept properly. Using the FCC-established, industry-wide rate of return, revenue requirements and prices become a matter of simple arithmetic.

Upon receipt of this streamlined cost-of-service showing, the reviewing authority could either accept the attached auditor's statement or direct its own accountants to review the underlying books. This would greatly reduce the burdens on the franchising authority and the Commission, while both assuring the operator an opportunity to recover its cost of service and providing subscribers a reasonable rate. The Viacom proposal outlined in these comments is thus simple, straightforward, and fair to both operators and subscribers.

V. IF ANY AFFILIATE TRANSACTION RULES ARE DEEMED NECESSARY, THE COMMISSION SHOULD ADOPT RULES THAT LOOK TO THE MARKETPLACE TO DETERMINE THE LEGITIMACY OF COSTS INCURRED IN SUCH TRANSACTIONS

The Commission proposes to adopt rules governing transactions with affiliated entities in order to "prevent cable systems . . . from imposing the costs of nonregulated activities on regulated cable subscribers through improper cross-subsidization." Cost-of-Service NPRM at ¶ 67. The Commission has expressed concern that, in transactions involving affiliated entities, the "prices set by affiliates may not accurately reflect market prices." Id.

As an initial matter, the Commission must consider whether, based on the record, there is any reason to devote even a portion of its limited resources to the regulation of transactions with affiliated entities. The record does not demonstrate any history of abuse in this area. Absent such a demonstration, Viacom submits that the Commission's limited resources should not be spent on a purely speculative problem. In the event abuses do occur in the future, the Commission could quickly and more than adequately address the problem at that time.

This approach is vastly superior to a blanket, all-encompassing regulatory scheme that would serve only to hinder the efficient operations of the market. The Commission has recognized the possible benefits of vertical integration in the cable industry. See Cable Horizontal and Vertical Ownership Limits, Cross-Ownership Limitations and Antitrafficking Provisions, 8 FCC Rcd 210, 216 (1993) (Notice of Proposed Rulemaking and Notice of Inquiry). To impose rules restricting transactions with affiliated entities that are more stringent than reasonably necessary would deprive cable operators -- and ultimately consumers -- of the benefits of these efficiencies. Moreover, adoption of restrictions here would prejudge the outcome of the Commission's ongoing inquiry into further regulation of vertically integrated companies. See id.

In the event the Commission nonetheless deems it necessary to adopt rules at this time, Viacom suggests that cable operator transactions with affiliated entities be recognized as legitimate as long as they are consistent with prevailing company prices offered in the marketplace to third parties. See Cost-of-Service NPRM at ¶ 68. In particular, the legitimacy of the cost can be determined by looking to the price of a sale, or the average price of multiple sales, of the same or similar product or service to any third party. Absent any such transaction, the cable operator should be allowed to provide evidence as to the "prevailing market prices" of the product or service as provided by others. For example, a cable operator should be allowed to submit prices paid by an entity for the same or similar service or product from an independent supplier. Moreover, as explained below, there particularly is no reason to place any additional restraints on the sale of programming to an affiliated entity.

VI. THE COMMISSION SHOULD APPLY THE NPRM'S PROPOSED MARKETPLACE APPROACH TO DETERMINE THE LEVEL OF PROGRAMMING COSTS WHICH CAN BE PASSED THROUGH UNDER PRICE CAP REGULATION

The Commission also asks whether any cost-of-service rules governing transactions with affiliated entities should be likewise applied in the benchmark regime to determine the ability of cable operators to "pass through" increases in the cost of programming obtained from affiliated entities. Cost-of-Service NPRM at ¶ 67. As explained above, Viacom strongly supports an approach that would allow a cable operator to look to the marketplace to determine the legitimacy of such programming cost increases. Transactions with unaffiliated entities provide a certain and ready barometer by which to test the legitimacy of any charge made by a program service to an affiliated cable operator.

For Viacom, the costs incurred through the acquisition of programming will be a major component of its transactions with affiliated entities. The approach outlined above will not only ensure that no improper cross-subsidization is occurring but, as demonstrated in Viacom's Petition for Reconsideration and Clarification in the benchmark proceeding, it will also avoid the reduction in the amount and quality of programming available to consumers that would inevitably result from any limitation on the ability of cable operators to pass through costs associated with programming obtained from affiliated entities. Indeed, Viacom believes in this proposition so strongly that even if, as suggested above, the Commission appropriately determines that it is unnecessary at this time to adopt any cost-of-service regulations governing transactions with affiliated entities, the marketplace approach should nonetheless be used to determine the ability of a cable operator relying on the benchmark approach to "pass through" any increase in the cost of programming obtained from an affiliated program service.

VII. THE COMMISSION HAS NO BASIS AND NO NEED TO IMPOSE AN ADDITIONAL PRODUCTIVITY FACTOR TO OFFSET INFLATION ADJUSTMENTS UNDER THE BENCHMARK/PRICE CAP MECHANISM

Notable among the few issues raised in the Cost-of-Service NPRM that relate only to the benchmark/price cap regime is the proposed productivity offset. Previously, the Commission announced that, on a going forward basis, cable operators will be able to adjust their benchmark rates annually to reflect inflation (as measured by the GNP-PI). The Commission now asks whether it should adopt a productivity factor to offset in part this inflation index. See Cost-of-Service NPRM at ¶¶ 81-85. Viacom submits that, given both the inherent structure of the benchmark/price cap mechanism and the absence of data sufficient to determine the appropriate level for any productivity offset, the Commission cannot reasonably adopt an offset at this time.

First, as the Commission recognizes, the benchmark regime already takes productivity into account in at least two ways. The GNP-PI itself "automatically reflects certain productivity gains in the economy." Cost-of-Service NPRM at ¶ 83. Moreover, the "benchmark formula includes declining per channel rates with an increase in the number of channels." Id. at ¶ 82 n.93. Thus, the question to be asked is not whether the Commission should impose any productivity offset, but whether there is any need to impose an additional productivity factor.

Even if the FCC believes such a need may exist, the record does not contain sufficient information to establish a proper productivity offset. In the telephone arena, the Commission imposed a productivity offset based on numerous studies that examined productivity in the telecommunications industry over periods of up to 50 years. See, e.g., Policy and Rules Concerning Rates from Dominant Carriers, 4 FCC Rcd 2873, 2976 (1989). There simply is no similar set of data on which to base a productivity offset for the cable industry.

Without a sufficient record, it would be a mistake to impose any offset. An inappropriate offset presents a serious potential to retard long term investment in both infrastructure and programming that far outweighs the short-term benefits to consumers in the form of somewhat lower prices. This is especially important given the inherent uncertainty as to the long-term effects of the newly imposed rate regulations in general. In sum, Viacom urges the FCC to act cautiously and refrain from imposing any additional productivity offset. The risk of harm is too great.

CONCLUSION

Viacom respectfully urges the Commission to adopt the rate base valuation methodologies and additional streamlining proposals described above. Specifically designed to replicate competition and ensure an orderly transition into rate regulation, this comprehensive package offers the Commission an administratively feasible approach to fulfilling its mandate to allow cable operators to recover no more and no less than the reasonable costs of providing regulated cable service, including the cost of capital. Accordingly, the Commission should adopt this proposal for a viable, cost-based alternative to its primary benchmark/price caps approach.

Respectfully submitted,

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ORIGINAL

RATE BASE ISSUES

IN CABLE TELEVISION COST-OF-SERVICE REGULATION

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RATE BASE ISSUES
IN CABLE TELEVISION COST-OF-SERVICE REGULATION

I. INTRODUCTION AND SUMMARY

The Federal Communications Commission issued a Notice of Proposed Rulemaking in MM Docket No. 93-125 dated July 15, 1993 (hereafter, "NPRM") that proposes regulatory requirements to govern cost-of-service showings by the cable television operators. The Brattle Group has been asked by Viacom International, Inc. to address the rate base issues raised by the Commission's NPRM. In particular, we have been asked to address:

- The economic principles that should govern the rate base methodology selected;
- The economically appropriate starting rate base for cable companies; and
- The need for on-going compatibility between regulation based on competitive prices and regulation based on the cost of service.

We believe we are qualified to address these tasks. Although The Brattle Group is a young firm, the firm's members collectively have several decades of experience with cost-of-service regulation. A particular focus has been rate base and valuation issues, which we have addressed in a variety of settings in the U.S. and abroad that involved both regulated and unregulated industries. Appendix A contains more details on my (Kolbe's) qualifications. I was assisted in the preparation of this report by Susan E. Vitka, who has addressed these valuation issues with me and with Professor Stewart C. Myers of MIT (also a member of The Brattle Group) in a number of previous matters. Ms. Vitka has completed the requirements for her Ph.D. in economics from Harvard University and is expecting the degree to be awarded in the near future.

Our findings may be summarized as follows:

- The Commission appears to want to establish competitive prices as the standard for cable regulation. As economists, we endorse this goal whole-heartedly. However, some of the detailed proposals within the NPRM are inconsistent with a competitive price standard.

- The starting rate base under cost-of-service regulation should be set at competitive market value in order to avoid uncompensated losses to cable companies caused by the transition to rate regulation.

- Concerns have been raised that the market value of cable companies may exceed the level that would be expected under more competitive circumstances because expected future monopoly profits have been capitalized into the asset values. While there are a variety of ways to estimate market value, it is more difficult to estimate *competitive* market value in the cable industry. We explored several alternative approaches to this problem and have concluded that the most feasible approach is based on an analysis of stock price movements for publicly traded cable companies over time. Based on such an approach, we conclude that capitalized monopoly profits are likely to represent less than 10 per cent of the pre-regulation value of cable companies assets.

- A rate base standard based on the competitive value of cable assets will send the proper signals to investors and will benefit customers (in part by avoiding "rate shocks" from major new investments). Historical book costs bear virtually no relationship to the value of competitive firms, particularly in rapidly growing industries such as cable. Thus, the Commission should not adopt a rate base standard based on net historical costs.